Palomar

First Quarter 2020 Earnings Call Transcript
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PRESENTATION

Operator

Hello and welcome to the Palomar Holdings, Inc. First Quarter 2020 Earnings Conference Call.

During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference line will be opened for questions with instructions to follow at that time. As a reminder, this conference call is being recorded.

I would now like to turn the call over to Mr. Chris Uchida, Chief Financial Officer. Please go ahead, sir.

Chris Uchida

Thank you, Operator, and good morning, everyone. We appreciate your participation in our first quarter 2020 earnings call. With me here today is Mac Armstrong, our Chief Executive Officer and Founder. As a reminder, a telephonic replay of this call will be available on the Investor Relations section of our website through 11:59 pm Eastern Time on May 13, 2020.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about the Management’s future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risks, uncertainties, and other factors that could cause actual results to differ materially from those indicated or implied by such statements, including, but not limited to, risks and uncertainties related to the COVID-19 pandemic. Such risks and other factors are set forth in our quarterly report on Form 10-Q, and will be filed with the Securities and Exchange Commission today, May 6, 2020. We do not undertake any duty to update such forward-looking statements.

Additionally, during today's call, we will discuss certain non-GAAP measures, which we believe are useful in evaluating our performance. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with U.S. GAAP. A reconciliation of these non-GAAP measures to the most comparable GAAP measure can be found in our earnings release.

At this point, I'll turn the call over to Mac.

Mac Armstrong

Thank you, Chris, and good morning, everyone.

Before I discuss our strong first quarter results, I want to take a moment to address the global COVID-19 pandemic and how our team at Palomar has responded.

First off, our thoughts continue to be with all those impacted by the disease. We also thank those working tirelessly to stem the impact of the pandemic. We hope that all participants with us today are safe, and most importantly, healthy. Our number one priority, is, and remains, the health and safety of our employees and all constituents within the Palomar network. It is important to point out that Palomar was founded and architected to manage catastrophe risk. As such, maintaining and executing a comprehensive business continuity plan has always been a key competence of our organization.

As COVID-19 began to spread throughout the U.S. in early March, we quickly mobilized our employee base for remote work, leveraging existing business continuity plans and practices developed previously for natural catastrophes. Since that time, nearly all of our employees have been working from home, save for a small group performing tasks that are essential in an office environment. Our remote workforce is operating seamlessly and productivity has not been compromised due to not only our cloud-based technology infrastructure but also the professionalism of the Palomar team. For our customers and partners, it is “business as usual” when it comes to our service standards and transactability. I would like to thank our employees who smoothly adapted to this environment during these extraordinary circumstances.

But, in reality, it is not business as usual for our insured’s and society in general. As we address the challenges posed by the evolving COVID-19 pandemic, our Company is focused on assisting policyholders with their individual needs. We have implemented an insurance premium grace period to accommodate late payments across all lines of business in all states where we operate. While the risks in our portfolio of specialty property insurance products have not seen a reduction in exposure or hazard, we continue to assess additional methods to help our policyholders and the communities in which they live.

Before I detail our first quarter results, I want to take a moment to briefly touch on the business interruption exposure of our commercial lines book and the coverage offered in these policies. Our All Risk and Commercial Earthquake (Difference in Conditions) policies offer business interruption coverage for insured’s for a loss in business income caused by physical damage to the structure from a covered peril. All of these policies are written on an admitted basis and all of our All Risk policies have an ISO virus exclusion in addition to requiring physical damage to the property. Our DIC policies require physical damage to the structure caused by the covered perils, whether it be an earthquake or flood.

We believe our policy language and coverage’s are expressly clear in that they exclude damage from a virus and require physical damage to the property. That said, we are acknowledging, investigating, assessing and adjudicating each and every one of our BI claims and providing the policyholder requisite consideration. We recognize the public policy making process is an extremely fluid one and we continue to monitor developments at all levels of government on the matter of business interruption insurance. Regardless, we have reinsurance coverage for these policies through our Excess of Loss and per risk programs.

We currently do not see any other areas of potential loss from COVID-19 in our portfolio as we do not write lines of business like event cancellation, workers compensation, surety, trade credit or casualty lines where the exposure is materially changing.

Separately, I want to spend a moment highlighting a specific event, the March 18th earthquake in Utah. First and foremost the earthquake just outside of Salt Lake City was another example of Palomar swiftly assessing and responding to a natural disaster. It also substantiates how the exposures of the specialty property insurance market and the needs of our policyholders are in no way diminished during the pandemic. The earthquake had a magnitude of 5.7 and was the largest in the state since 1992. Immediately following the event, our team and claims partner worked quickly and diligently to contact policyholders in the area to ensure their safety, offer support and review our exposure, which included 586 total earthquake policies within a ten mile radius of the epicenter. Fortunately, losses from the event will have a minimal impact on our earnings in the first quarter and beyond.

Turning to our results, the first quarter provided another successful demonstration of Palomar executing on its strategic plan to build a leader in the specialty property market. Our existing products continue to grow, taking share and driving adoption; we continue to invest in new segments like inland marine; our geographic reach is expanding; and we accomplished all this while generating strong returns. We believe these efforts are best reflected by our growth and profitability during the quarter.

Overall gross written premiums grew 32.3% compared to the prior year period. It is worth noting that the results from the first quarter of 2019 included the one-time assumption of $6.6 million in unearned premium in conjunction with a residential earthquake carrier partnership that commenced during that quarter. Excluding the impact of that new partnership last year, gross written premiums increased by 50.8% year-over-year and our residential earthquake products grew 26.7%.

Major growth drivers in the first quarter were our commercial earthquake and commercial all risk lines, which grew gross written premiums by 66% and 65%, respectively, compared to the prior year period. Commercial lines growth was a function of new distribution sources and geographies, further product traction and most importantly sustained pricing increases. Our first quarter commercial policy composite rate increase on renewals was 12.7% versus 11.2% in the fourth quarter.

During the quarter, our entire book experienced premium retention rates of 90%, compared to 89% in the fourth quarter. Premium retention for our Residential Earthquake, our largest line of business, Commercial Earthquake and Hawaiian Hurricane products were in excess of 94%. We believe these results are a testament to the unique value we offer across the Palomar network.

Loss and loss adjustment expense, which Chris will detail shortly, totaled $1.9 million during the quarter, generating a 5.4% loss ratio. As a result, we achieved an adjusted combined ratio of 61.6% and an adjusted ROE of 20.6% during the quarter. I feel it is worth highlighting that we achieved that ROE in spite of a conservative net written premium to ending stockholders' equity ratio of 0.64 times.

Our balance sheet remains very strong bolstered by the $35.5 million capital infusion from our January following offering, we are debt free, we do not hold exposure to the equity market, and our investment portfolio consists mainly of highly liquid and high-quality fixed income securities.

We continue to invest in our team as we seek to scale our capabilities and footprint in the market. During the quarter, we made strategic hires in underwriting, technology and operations, and we are still hiring via a virtual recruiting process rather than in person. We also built out our senior leadership group with the hiring of Bill Bold as our Chief Strategy Officer and the promotion of Jon Christianson to Chief Underwriting Officer and Chief Operating Officer effective August 1.

I would be remiss if I didn't take a moment to thank our current Chief Underwriting Officer, Andy Robinson, who will be leaving the Company in August. Andy has been instrumental in our success since he helped launch Palomar in 2014. We are going to miss Andy dearly and wish him well as he transitions to spend more time with family and pursue other personal endeavors.

We are fortunate that our products serve an important enduring need to consumers and businesses in a way that is generally independent of economic conditions. That said, we are by no means impervious to the impact of COVID-19 on our business and the insurance industry, in particular its tumult in matters regarding business interruption insurance. While BI is a very modest contributor to our overall insurance limit, we are very focused on this evolving dynamic. In the interim, we will appropriately respond to the needs of our policyholders. During these extraordinary times, our team remains committed to the long term opportunity in front of us and to serving all our stakeholders.

With that, I will turn the call over to Chris to discuss our results in more detail.

Chris Uchida:

Thank you, Mac.

Please note that during my portion, when referring to any "per share" figure, I am referring to "per diluted common share" as calculated using the treasury stock method.

For the first quarter of 2020, our net income was $11.8 million, or $0.48 per share, compared to a net loss of $14.4 million, or a loss of $0.85 per share, for the same quarter in 2019. For the first quarter of 2020, our adjusted net income was $12.3 million, or $0.50 per share, compared to adjusted net income of $8.8 million, or $0.52 per share, for the same quarter of 2019. First quarter 2020 and 2019 adjusted net income excludes expenses related to our stock offerings and stock based compensation, including the tax impact of those expenses. These stock offerings have increased our shares outstanding by approximately 7.2 million shares or 42% during the past year.

Gross written premiums for the first quarter were $71.5 million, representing an increase of 32.3% compared to the prior year's first quarter. As Mac indicated, last year's results included the inception of a Residential Earthquake partnership in which we assumed $6.6 million of in-force premium. Excluding the impact of that 2019 premium assumption, the period-over-period increase was 50.8%. We saw robust new business, rate increases, and strong premium retention with contributions across our product portfolio.

Ceded written premiums for the first quarter were $29.5 million, representing an increase of 13% compared to the prior year's first quarter. Our risk transfer strategy remains a critical component to our business, especially as we demonstrate sustained topline growth. The increase was primarily due to an increase in the reinsurance expense commensurate with our growth.

As we grow our business, we expect to incur additional excess of loss reinsurance expense as we maintain a conservative level of overall coverage. Due to the timing of our reinsurance placements and terms of the underlying contracts, there may be a lag between earned premium and a reinsurance placement or expense, but over time we expect these impacts to smooth out and their trends to look the same. As of January 1 of this year, we retained $5 million per earthquake or wind event, and we purchased $1.2 billion of total reinsurance coverage for California earthquake events.

Net earned premiums for the first quarter were $34.8 million, an increase of 89.7% compared to the prior year's first quarter. Our results improved primarily due to the earning of increased gross written premiums offset by the earning of ceded written premiums under reinsurance agreements. For the first quarter of 2020, net earned premiums as a percentage of gross earned premiums were 53.6% compared to 44.9% in the first quarter of 2019. As previously discussed, we believe the ratio of net earned premiums to gross earned premiums is a better metric for assessing our business versus net written premiums to gross written premiums. With our current mix of business we expect that ratio to be around 50% on an annual basis.

Commission and other income was approximately $738,000 for the three months ended March 31, 2020, and $586,000 for the same period in 2019, due primarily to an increase in policy-related fees associated with an increased volume of premiums written.

Losses and loss adjustment expenses, or LAE, incurred in the first quarter were $1.9 million, compared to $316,000 in the prior year's first quarter. Our losses during the quarter were primarily made up of attritional losses as well as modest losses including IBNR of approximately $192,000 from the March 18 Salt Lake City Earthquake. In addition, we booked approximately $316,000 of favorable prior year development. Our loss ratio for the quarter was approximately 5.4% compared to 1.7% for the prior year's first quarter. Our loss ratio increased in the first quarter of 2020 primarily due to increased attritional losses in our Commercial All Risk and Specialty Homeowners lines. During the first quarter of 2019, we ceded all losses related to our Specialty Homeowners line in the state of Texas.

Our expense ratio for the first quarter of 2020 was 58.2% compared to 192.1% in the same quarter of 2019. The combined ratio for the first quarter was 63.6% compared to a combined ratio of 193.8% for the prior year's first quarter. During the first quarter of 2019, the IPO-related expenses and the $23 million stock compensation charge incurred as a result of our IPO significantly impacted our expense and combined ratios. Our adjusted combined ratio, which we believe is a better assessment of our efforts, was 61.6% during the first quarter compared to 66.7% in the prior year's first quarter. We believe our business will continue to scale over the long term.

Net investment income for the first quarter was $2 million, an increase of 112% compared to the prior year's first quarter. The increase was largely due to interest income generated by the $122.9 million of net proceeds received from the Company's stock offerings and positive cash flows from operations. Funds are generally invested conservatively in high-quality securities, including government agency, asset and mortgage-backed securities, municipal and corporate bonds with an average credit quality of A1/A+.

Our fixed income investment portfolio yield during the first quarter was 2.85% compared to 3.10% for the first quarter of 2019. The weighted average duration of our fixed-maturity investment portfolio, including cash equivalents, was 3.81 years at the end of the quarter. Cash and invested assets totaled $320.4 million at quarter end as compared to $159.6 million at March 31, 2019. For the first quarter, we recognized realized and unrealized gains on investments in the consolidated statement of income of $0.4 million compared to a $2.4 million in the prior year's first quarter.

Our effective tax rate during the first quarter was 22.3% compared to a negative 1% for the prior year's first quarter. Our prior year tax rate was significantly impacted by the reversal of the valuation allowance on the Company's federal deferred tax assets and add back related to the stock compensation charge recognized during the quarter. Excluding any unforeseen events, we anticipate that our tax rate will settle in around the 21% mark for 2020.

Our stockholders' equity was $260.8 million at March 31, 2020, compared to $101.9 million at March 31, 2019. For the first quarter of 2020, annualized return on equity was 19.7% compared to a negative 58.2% during the first quarter of 2019. Similarly, our annualized adjusted return on equity during the first quarter was 20.6% compared to 35.7% during the first quarter of 2019. The year-over-year changes in our annualized return on equity and our annualized adjusted return on equity include the impact from a sizeable increase in the Company's stockholder's equity as a result of $122.9 million of capital raised from multiple stock offerings.

While COVID-19 adds a high degree of uncertainty to the society at large, we remain steadfast in our ability to execute and achieve adjusted net income between $50.5 million and $53 million for 2020, which equates to a growth rate of 33% to 40% year-over-year. It is worth emphasizing that these results assume there are no major losses from a natural catastrophe and/or those caused by business interruption legislation.

As of March 31, 2020, we had 24,778,608 diluted shares outstanding as calculated using the treasury stock method. We do not anticipate a material increase in this number during the year ahead.

With that, I'd like to ask the Operator to open up the line for any questions. Operator?

Operator

Thanks. We'll now be conducting a question-and answer session. If you'd like a place in the question queue, please star, one on your telephone keypad. Our confirmation tone—excuse me. A confirmation tone will indicate your line is in the question queue. One moment, please, while we poll for questions.

Our first question today is coming from Mark Hughes from Sun Trust. Your line is now live.

Mark Hughes

Thank you very much. What sort of take rate have you seen on the offer of a grace period on your policy?

Mac Armstrong

Hey, Mark, it's Mac. What I would say is we haven't really been able to track it. What I would tell you is retention in March and what we're seeing as we sit here in April is consistent with maybe a modestly tick up. Most of our interaction is anecdotal. In speaking to insurers that want to understand their payment plans, want to understand what the grace period entails but it's too early, really, to synthesize what it entails.

The only thing that I would add is most of our products have some technical payment options, but they're not twelve pay. They tend to be three or four pay periods, so in many instances lots of people prepaid.

Mark Hughes

Am I to understand that the information you've gotten back, any specifics at this point, is fairly limited? Is that the…

Mac Armstrong

Yes. It's really—the first full month of it being in the market would be April, so it's early to tell. I think it's going to be better told—the story will be better told in the second quarter.

Mark Hughes

Oh, go ahead.

Chris Uchida

I was going to add one things that—it's something that we're watching closely and we look at our cash collections and things of that nature on a daily basis, and we haven't seen a real significant change since a lot of those grace periods have been implemented.

Mac Armstrong

Yes, I've seen no change.

Mark Hughes

Very helpful. Thank you. Chris, the XOL purchase timing, your earned premium, pretty healthy this quarter and presumably above the longer term norm, that 50% of the written premium. Any detail you can provide about that? What would was the benefit this quarter and when would you anticipate that the XOL purchases might have a step of impact?

Chris Uchida

Yes, I think that was well-said, Mark. When I look at it for Q1, there was obviously the January placement that you mentioned. The key driver for the favorable results on the ratio was really the growth in written premiums. That growth was—it was throughout the quarter, but it did start in early January, so we did receive a significant benefit in the earnings of all or a significant portion of that growth during the quarter, so that definitely helped the Q1 results. We haven't announced any of our reinsurance placements for the remainder of the year. I can say that we did not have any new excessive loss in the first quarter or else we would have disclosed that. I think if you look at some of the information that we provided in prior years that can give you a good sense of what our reinsurance cycles usually are.

With that, like you said, over the long term I would still expect that ratio to be around 50% for an annual basis for 2020.

Mark Hughes

Mac, if you wouldn't mind, just a little more on market conditions both in California, as it pertains to turnover or dislocation in the residential market, that may be giving you opportunity to sell your policies, and then also the commercial line more broadly of what you're seeing in the opportunities in commercial quake.

Mac Armstrong

Sure, Mark. In the residential quake, what I would say is we grew on a same store basis, for lack of a better term, 25%—some 26.7%, and we continue to have strong new business in the first quarter. There remains the dislocation in the homeowners market and so I think that's creating partnerships as well as new distribution arrangement opportunities. I think our distribution footprint across all of Palomar grew 6% in the first quarter, so we feel pretty good about the momentum that we continue to see there.

I think, candidly, with the shelter-in-place mandate, people are reminded of the importance of the structure and protecting the structure that is their home. New business volumes are sustained even as we speak today.

On the commercial side, the dislocation in the commercial property market is—was—continued to be pronounced in the first quarter. I mentioned the 12.7% rate increase that we saw, and how that picked up from 11.2% in the fourth quarter. Candidly, I think it's going to be more pronounced the later half of this year. I think it's a function of COVID-19 and losses being taken in other lines of business and forcing people that are writing commercial property to retrench or cut back their limits that they're allocating.

I think also the reinsurance market is hardening, which will impact others in what they can write, and that's probably relevant for commercial earthquake, so all risk in or inland marine. We actually believe that the dislocation is going to be more pronounced in the second quarter and the second half of this year which I think creates opportunities for us. We have a strong reinsurance program in place. We have ample capital that was bolstered in the first quarter. I think the prospects for commercial business, at least on the underlying cost of a unit of exposure of insurance, is strong.

Mark Hughes

Super. Thank you.

Operator

Thanks. Our next question today is coming from Paul Newsome from Piper Sandler. Your line is now live.

Paul Newsome

Good morning. Any possibility or early lead on market demand impact because of the Utah earthquake? Obviously it changed quite a bit after the California earthquake of last year, but any thoughts there?

Mac Armstrong

Yes, Paul. It's Mac. Good to hear from you. What I would say is it has followedhow we've seen in other states where there is a big surge in demand following an earthquake. In Utah, our new business ticked up considerably. Now I need to temper that with the fact that the average premium in the overall size of that market is very small in comparison to California.

It's a catalyst and it certainly helps from a spread of risk in the diversification standpoint because we're writing a lot more Utah Earthquake business than we ever have, and it creates some awareness in California. We think that will help with new business. It happened March, and will help in the second quarter some, but it will not be certainly as material as it was in the case of July when the earthquake was in Southern California.

Paul Newsome

Is there anything that's happened in the last month or so here with the pandemic and other effects that would change how you think about risk? Particularly with the all-risk policies, I would guess. Thoughts about changes in terms of conditions, thoughts about limits, anything that you would think about adjusting over time based upon what you experienced of late?

Mac Armstrong

Paul, what I would say—it's a very good question. What I would say is we feel very, very confident in our approach and how we've underwritten our all-risk business by having the ISO virus exclusion in every single one of our policies, and that's a form that's been in the market since, I believe, 2007. I would say that we are not going to deviate from the inclusion of that exclusion in all of our policies. I think we are going to continue to underwrite certain classes that maybe some people will have pulled out from if we know that they have a clear operating plan for when they are open and fully functional.

A lot of—I'll give an example of hotels and motels. They are operational and they are open, but they're not truly fully functional, so we, as we underwrite those, we want to understand what is their true return to work and return to full capacity function. I think we are going to just continue to be adamant in the inclusion of balanced exclusions and not putting ourselves in a position where there is a shadow of doubt in coverage or lack thereof.

Paul Newsome

Thanks. Congratulations and look forward, guys.

Mac Armstrong

Thanks, Paul.

Operator

Thank you. Our next question is coming from Jeff Schmitt from William Blair. You line is now live.

Jeff Schmitt

Hi, good morning. I think you said that growth of distribution was 6%. Is that basically of distribution partners? I'm just wondering if you could maybe provide some detail on the components, retail, MGA, carrier, and is that changing at all here with, I guess, the pandemic? Is that affecting that?

Mac Armstrong

Yes, Jeff. Our total of distribution footprint increased by 6% in the first quarter. That's across all lines of business. It was more for that—residential earthquake was about 7%. Our commercial all-risk—so it's been more pronounced in commercial lines. Commercial all-risk, the total producers increased by 22%. Then inland marine, which obviously is coming from a much lower base, anecdotally increased 91%. The mix of that is going to be more residential and wholesale. Commercial production is predominantly wholesale-driven, although the inland marine does have a combination of wholesale and retail.

What I would tell you is its nonspecific, it's growing across the board, it's more pronounced in commercial business, and it's going to be more wholesale and retail. We have some terrific program administrator partners who are residential, earthquake, and specialty homeowners lines, and we're not really broadening that arrangement right now.

Jeff Schmitt

Okay. I mean, you may have touched on this, but I guess given the jump in unemployment here, and I guess just given that a number of these products are add-ons, I mean, they're optional, are you seeing a big pullback in demand for some of those products?

Mac Armstrong

No. Jeff, what I would say is we are not as of this point. We affirmed our guidance in May, right, with April in our rear view. The trends in that—what we've seen there, we had strong retentions in May. Excuse me, in March. Forgive me. For the quarter it was 90%. I think it comes back to—while you're correct, it's our largest line, the residential earthquake is a voluntary product. You have to go back and look at the buyer. The buyer tends to be a mass affluent buyer. The average TIV across the board is close to $1 million. That's the total insured value is close to $1 million. They're probably a middle-aged buyer, so—and they're sheltering in place right now, so they're seeing a consistent reminder of their asset and protecting that asset. Then when you feather in some pretty material events in the form of earthquakes in not just in Utah but also even in Idaho, and some small ones in California, I think awareness sustains retention, too. The longwinded way of saying so far we have not.

Now I'd be foolish to think that may—that couldn't change. It could change. But from what we're seeing right now, retention is holding strong.

Jeff Schmitt

Okay. That's helpful. Thank you.

Operator

Thanks. Our next question is coming from David Motemaden from Evercore. Your line is now live.

David Motemaden

Thanks. Good morning. I had a question for Mac, just on the reinsurance renewals for 6/1. Wondering what your preliminary views are on pricing for the part of your program that's renewing. Then I think you also had the Torrey Pines CAT bond that's also going to renew or is renewing pretty soon here, and what your outlook is on the pricing given all the noise that's been thrust into the marketplace from COVID.

Mac Armstrong

Hey, David. It's Mac. It's good. It's a great question and first of all, I'm pleased to report that we have placed all of our reinsurance program as we sit here today. We will have a press release out in the next couple of weeks that goes into more detail. We are finalizing contract terms and conditions and signing final lines, but all the limits have been placed. We were thrilled to report that. What I would say is the reinsurance market is hardening as it relates to Palomar. It's hardening in a digestible fashion and it's one that frankly, while we'll see a risk-adjusted increase in the cost of reinsurance, it somewhat cuts in—in many ways it's catching up with what we've seen in the primary market.

I also believe that what it will lead to is further dislocation in the primary market that will allow us to recoup or sustain our margins, generally speaking. The market is changing and I think one of the drivers of it was the second question that you asked, was around the ILS market. For us, we were anticipating going out in the ILS market. We pivoted pretty quickly when we saw illustrative pricing and some of the terms and conditions that were being put in the market in March. We decided to not go down that path. Again, this will be described in more detail in a press release, but we've gone back to the traditional market. We've got a great reinsurance panel that supported us and we're—again, we're pleased that it's wrapped up in one—the bow is on the program so to speak. We'll have a press release out in the next week or two.

David Motemaden

That's good to hear.

Chris Uchida

Hey, Jeff. Just for a little clarity around that also. I would like to add that when we looked at the guidance that we did provide, we were able to contemplate a lot of that reinsurance placement in some of our projections, so we have considered that in the—I guess the aggregation of those numbers that we provided.

Mac Armstrong

Okay. Yes, that's a good point, Chris. Thanks.

David Motemaden

Got it, thanks. Thanks, Mac and Chris, for that. Then I guess, is there any follow-up around—you obviously are now at $260 million of equity. Any thought around increasing the retention from $5 million to maybe something higher, and just your thought process around that?

Mac Armstrong

Yes, Dave. Yes, that's a good question, and I think we've talked in the prior earnings calls and outlined what our guideposts are, in that we will keep our retention inside of 5% of surplus and no more than a quarter of pretax earnings. I think that's what you'll see when we announce it. The cost of those lower layers get pretty expensive and, frankly, the payback is very quick, so that will be fleshed out. I would say the retention's going to be ticking up, but it's going to be inside of those parameters that we've kind of deemed somewhat sacrosanct.

David Motemaden

Great. Thank you.

Operator

Thanks. Our next question is coming from Meyer Shields from KBW. Your line is now live.

Meyer Shields

Great, thanks. Good morning. I was hoping we could talk a little bit about the commercial customer's economic disclosure, analogous to your comments earlier about your residential earthquake customer.

Mac Armstrong

Yes, Meyer. With respect to our commercial business, and I think it's overarching. It's worth pointing out, obviously we write specialty home loan—or specialty business, specialty property business. Overarchingly, our book is very habitational in nature, and so if you look at the totality of our book, 82% of the gross written premium and about 89% of the locations that we write are habitational in nature. They could be HOAs, single family homes, institutional housing, and things of that sort. Generally speaking, our book tends to be a pretty homogenous book of habitational exposure.

The commercial lines writes—a lot of that habitational is to also write a fair bit of hotels and motels and—builder's risks or lessors' risks, so think strip malls. Not a lot of heavy manufacturing, not a lot of contingent business interruption. For lack of a better term, somewhat plain vanilla. If you look at what we're seeing in the commercial market right now, I think a trend that's fairly consistent is you are not seeing people looking to switch too often and they are going to stay with their existing incumbent carrier, even with a 12%, 13%, 14%, 15%-plus rate increase because they just don't want to create a circumstance of uncertainty. Furthermore, when there is a shift from one carrier to the next, it's going to be driven by this affirmation dislocation in the market that we feel can become more pronounced the latter half of this year.

You're able to bring that on at pretty attractive terms and conditions, whether it's the underlying, A, other premium metrics or the unit cost of insurance, or with terms and conditions. The commercial market, for what we write, is fairly predictable, it's fairly consistent in the returns and the underlying metrics that we're achieving, and the rate that we're able to glean.

Hopefully that answers your question.

Meyer Shields

It does. It was very helpful. I was wondering if you could contextualize the 6% distribution for footprint growth, maybe where it was over the course of 2019.

Mac Armstrong

Over the course of 2019, Meyer, it grew probably around 10% to 12% from the third quarter. The fourth quarter, it was pretty consistent. It was around 8%, 9% growth, I think. It went from 5,400 to 5,800 agents actively producing with us. It probably accelerated more in the first half of the year.

Meyer Shields

Okay. Thank you so much.

Operator

Thanks. Our next question today is coming from Matt Carletti from JMP Securities. You line is now live.

Matt Carletti

Okay, thanks. Good morning, Mac and Chris. Most of my questions have been answered. I just have one for you. As you think about the landscape ahead, I wanted to ask you what new opportunities do you see? Do you see opportunities coming out of, whether it's COVID or everything related to it, where there's either new risk exposures that clients are looking to insure or areas of the market where maybe competitors are impaired? Are there spots you have your eye on where we could see new opportunities for Palomar?

Mac Armstrong

Matt, thanks for the question. What I would say is the answer is yes to all of what you just touched upon. I think, first and foremost, I want to reiterate that we think there's considerable green field in our existing products and our existing markets. COVID-19's probably going to foster—dislocate—further dislocation and opportunities within those segments. We don't want to get too far afield when there is ample opportunity in where we are and traffic, in areas where we already traffic.

We are, indeed, looking at new emerging segments, and I think we just look at our own experience with Palomar. Our team has done an exceptional job of transitioning to a remote working environment, and we've done a very—we've tried to maintain constant communication with them all, and one of the things we've done is to try to take their temperature on whether or not they would want to return to work when the—California is indeed fully open.

Several have said they've really enjoyed the dynamic of working from home and would like to continue to do so indefinitely. I think there is going to be a paradigm shift in remote work and, therefore, the coverage that that necessitates in a force. That's an area that we are going to do considerable work on, especially when you think about, as I said earlier, 82% of our premium is habitational in nature. That is something for us to get our hands around there.

I can't tell you what that is right now, but I do think that is an emerging line of business that is tangential at a minimum to what we do.

Matt Carletti

That's been very helpful. Thanks for the color and congrats on a nice start to the year.

Mac Armstrong

Thanks, Matt.

Operator

Thanks. Our next question today is coming from Adam Klauber from William Blair. Your line is now live.

Adam Klauber

Thanks. In the residential earthquake client, I think you mentioned that you are seeing some different channels. In particular, how are, I guess, the new—some of the new competitors that's going to be more digital? Are you seeing more volume from them in March and April?

Mac Armstrong

Hey, Adam. I would say it's—those channels continue to perform well for us. The one thing that I would hesitate in saying that they're driving disproportionate growth is they're probably driving disproportionate growth from a pitch perspective, but they're not from a premium perspective. They tend to be more focused on a renter or a first homebuyer which is going to be a lower premium point than, as I mentioned, our average policyholder of residential earthquake, I think, is 45, mass affluent, who's been in their home for a long period of time, built up considerable equity in that home that they're protecting, so the premium's a bit higher there.

They're a very good channel, and they're a very good channel immediately following events because they do have that direct-to-consumer touch-point, but I would say it's more pitch count, policy count, than it is premium volume, that they drive growth.

Adam Klauber

Great. That makes sense. Then builder's risk. Obviously that business is jumping up after the newer business. Can you talk about the build-up of the footprint? Which states are you writing more business today? As we think about rollout of that business and that team, what sort of footprint do you expect to have by the end of the year?

Mac Armstrong

Adam, that's another good question. We're very excited about the traction we're getting in that segment. Right now, what we've tried to do is leverage existing distribution relationships, leverage existing reinsurance programs to kind of follow the track of our All-Risk Program and where we write. It's been more Texas and the Carolinas. Over time, we expect to see the geographic footprint broaden, in particular in the noncoastal or wind-exposed or—states, because builder's risk is not geographically limited. I would expect us to—we've got the balance approved in all 27 states where we were admitted, but I would expect just to see that start to deviate from the footprint of all risk or commercial earthquake over time. Right now, it's mirroring it fairly closely.

Adam Klauber

Okay, thanks. You covered this, but how does the flow of the business in the commercial all risk from the wholesale channel ticked in March and April as—have you seen it slow, is it around the same, or just—even, even just from a color standpoint. Has there been changes in the nature of the flow from the wholesale channel?

Mac Armstrong

Adam, I'll tell you. We increased in all—commercial. All risk, for instance, our distribution touch-points increased by 22% in the first quarter, so submission activity increased considerably. The metrics we're getting are trending up. They're continuing to improve from AAL topremium perspective from a premium renewal perspective, and submission count is increasing. I do think—I've used the term several times on the call, dislocation in the commercial property and all risk market has helped us tremendously in that line, and it's going to continue to do so.

Adam Klauber

Okay, great. Then switching. Other underwriting expenses moved up a little year-over-year. Obviously you're a bigger company today than a year ago. When you think about this level, I think it was a little over $7 million, will we see continual sequential jumps or do you think the rate of growth and then other expenses will slow a little compared to what we saw in the last couple of quarters?

Chris Uchida

Yes. I would say we haven't provided specific guidance around any of that, but I would say when you look at the sequential growth, all of it was planned and accounted for. When we thought about guidance we gave at the beginning of the year and then affirmed today, so I think it's all related—or most—a lot of it is related to the IPO and becoming a public company, especially when you look at Q1 of last year. We were not a public company yet in Q1 of last year, so there is some sequential growth there. I think this is at a pretty healthy level. I think we will continue to add as we need to grow and sustain that growth. But it should be at a—call it a scalable level where the top line of revenue does exceed the growth over the long term period of time.

Adam Klauber

Okay. Then finally, Chris, and I think you made this point earlier, obviously you're paying—you're paying some of the excess, extra slots for insurance up front, and you earned the premium throughout the year, so that suggests throughout the year the acquisition cost, if I understand it correctly, probably does moderate somewhat to what we saw last year. Is that correct?

Chris Uchida

Yes, I think—I'm not completely sure I'm following the question, but the placement of the excess of loss, so the January 1 did not cost a little bit on the upcoming placement that we'll announce later on, probably this month. At those periods of time, those earn out or those are expensed over the term of those contracts, so the next placement, let's call it June 1, that new reinsurance level, that will be the level of expense over whatever the term of those contracts are.

Mac Armstrong

Yes. I think the acquisition expense will then dovetail off of what the blended net in premium conversion rates, so if we just use 50%, the acquisition expense will be pegged off of the net or premium converting at 50% of the gross earned. I think it should be fairly steady, Adam. The only thing I would add, as commercial business grows, that, in the mix changes that should help tick down the cost of acquisition modestly. We think it's going to be fairly predictable.

Adam Klauber

Great. Thanks, guys.

Operator

Thank you. As a reminder, that's star, one to be placed in the question queue. One moment, please, while we poll for further questions.

We've reached the end of our question-and-answer session. I'd like to turn the floor back over to

Management for any further or closing comments.

Mac Armstrong

Well, thank you, Operator, and thank you, all, for the time this morning. This concludes Palomar's first quarter earnings call. We appreciate the time, the questions, and, always, your support.

We do believe that Palomar has the foundation in place to execute on our near and long term strategic initiatives. We think this quarter exemplifies how our company can and will persevere through these certainly challenging and unfamiliar times. We can't predict with utmost certainly what will transpire over the course of 2020. We can and will remain focused on providing strong results for all our stakeholders, while equally prioritizing the safety of our employees and our trading partners.

We look forward to speaking with you after the second quarter. I hope that you and your families remain healthy. Thank you very much and have a great day. Thank you for your time.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.